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IN THE

Supreme Court of the United States

October Term, 1958.

No. 305.

GEORGE HUSS, RUSSELL HUSS AND WESLEY HUSS,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR PETITIONERS.

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v.

FRANCIS R. SMITH, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF PENNSYLVANIA.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR PETITIONERS.

OPINIONS BELOW.

The Findings of Fact (R. 27) and Opinion (R. 37) of the District Court for the Eastern District of Pennsylvania are reported at 150 F. Supp. 224.

The Opinion of the Court of Appeals for the Third Circuit (R. 67) is reported at 255 F. 2d 599.

The Opinion of the said Court on Petition for Rehearing (R. 81) is reported at 255 F. 2d 601.

JURISDICTION.

The judgments of the Court of Appeals for the Third Circuit were entered on March 27, 1958 (R. 70-72). A petition for rehearing, timely filed, was denied on May 29, 1958 (R. 85). A petition for writ of certiorari, filed on August 25, 1958, was granted on October 13, 1958 (R. 86).

The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

STATUTES AND REGULATIONS INVOLVED.

The statutes involved are Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939, as amended, 26 U. S. C. (1952 ed.) Sections 23(m) and 114(b)(4). The pertinent text thereof is printed in Appendix A, *infra*, pages 19-20.

The regulation involved is Treasury Regulation 111, 26 Code Fed. Regs. § 29.23(m)-1 (1949). It is printed in Appendix A, *infra*, page 21.

QUESTION PRESENTED.

Where Petitioners acquired by agreement from the landowner the exclusive right to strip mine all coal on the land, and Petitioners assumed all risk and expense involved in the discovery and production of marketable quality coal, which the landowner agreed to buy at a stated price per ton, are they entitled to the statutory depletion allowance with respect to gross receipts from the coal mined by them in the taxable years where the landowner had a power which it did not exercise, to terminate the interest of Petitioners?

STATEMENT OF THE CASE.

These cases come before this Court on writ of certiorari to the United States Court of Appeals for the Third Circuit to review decisions of that Court which affirmed judgments of the United States District Court for the Eastern District of Pennsylvania denying Petitioners' claims for refunds of income taxes paid with respect to the calendar years 1944 to 1947, inclusive.

Petitioners were partners engaged in mining Anthracite by the strip-mine method. During the years 1944 to 1947 they were engaged in strip-mining lands located in Schuylkill County, Pennsylvania, pursuant to written agreements with the landowner, Philadelphia & Reading Coal & Iron Co. (hereinafter called P. & R.). These agreements

referred to separate tracts of land and are designated P-22 (May 27, 1944), P-22B (February 23, 1945), P-29 (May 8, 1945), P-30 (July 16, 1945), P-32 (December 17, 1945), and P-35 (July 19, 1946). All of the agreements pertain to specific areas in the so-called Tower City Tract, except P-30 the subject of which was an area known as the Forestville Area, approximately ten or twelve miles from the Tower City Tract (R. 27-28).

The agreements were almost identical, differing only in that P-22 contained a different termination clause (Pl. Ex. 1, Article 23, R. 86, 98; Ex. A, Article 23, R. 128, 139-140, and see R. 37, footnote 7) and in that each agreement called for a different price per ton for delivered coal which P. & R. was to pay to Petitioners.

By the terms of these agreements, P. & R. reserved specific areas of previously mined land and granted to Petitioners the exclusive right to discover and produce all the coal which might be found therein. P. & R. assumed no responsibility for the discovery of coal and gave no guarantee of the quantity of coal in the stripping area. The only obligation of P. & R. was to pay a stated price for each ton of coal actually delivered to it. In fixing the stated price, market values of coal were taken into consideration (Finding of Fact No. 26, R. 33). On the other hand, Petitioners expressly assumed "all risk in connection with the prospecting, discovery and recovery of coal and the operation of the entire stripping project" (Article 5, R. 91-92, 133-134). Among other obligations, Petitioners agreed to provide and pay for materials, labor, tools, equipment, water, light, transportation and all other facilities necessary for the mining operations (Article 10, R. 94, 136); to pay all taxes, carry liability insurance (Article 25, R. 99, 140), and to obtain and pay for all permits required by public authority (Article 27, R. 100, 141).

Petitioners determined when and where to begin, and when and where to stop strip mining in any area. They also determined whether or not it would be profitable to

begin strip mining. If they determined that it would not have been economically feasible to mine, they were not entitled to reimbursement for prospecting costs (Finding of Fact No. 17, R. 31). They paid the men who did the work and also paid for all equipment, supplies and materials (Finding of Fact No. 18, R. 31). Petitioners built roads, constructed buildings and supply houses. They commenced stripping operations with equipment valued at about $100,000. and by the end of 1947 had increased their investment to about $500,000. Most of their equipment was usable only for strip mining (Findings of Fact Nos. 19-21, R. 31-32).

Petitioners were compelled to look exclusively for their return and profit to the price per ton which P. & R. agreed to pay for coal actually delivered (Finding of Fact No. 16, R. 31).

Upon commencing operations under the first agreement, P-22 (R. 86), Petitioners produced a small amount of tonnage after three weeks, but it was at least two months before they produced sufficient tonnage to compensate them and to return a small profit (Finding of Fact No. 23, R. 33, R. 16-17).

No contract was ever terminated unilaterally by P. & R. In every case, when Petitioners had determined that they had exhausted an area, and ceased strip mining, the contract was terminated by a written agreement between P. & R. and Petitioners (Finding of Fact No. 31, R. 35). Although the District Court found that no particular duration of time was specified in the strip-mining agreements (Finding of Fact No. 31, R. 35), the agreements specifically gave Petitioners the right to all the coal recoverable by stripping (See Contract P-22, Article 1, R. 90; P-22B, Article 1, R. 131).

The Petitioners, in view of the substantial commitments and investments involved, were concerned with the 30-day cancellation provisions of the form agreements, and were advised that such provisions were inserted to permit P. & R. to sever relationships with unsatisfactory strip miners

without the necessity of resorting to legal proceedings (R. 9-11).

The District Court held that Petitioners had no "economic interest" in the coal in place and were therefore not entitled to the statutory depletion allowance pursuant to Sections 23(m) and 114(b) of the Internal Revenue Code of 1939 (R. 47). On appeal, the Court of Appeals for the Third Circuit affirmed, although it evidently believed there was a reasonable basis for characterizing Petitioners' status as involving an interest in the mineral in place. The Court of Appeals concluded that the standard to be administered was too vague to permit it to reverse the District Court (R. 68-69).

On Petition for Rehearing, Petitioners pointed out that the Court of Appeals had erred in its statement as to the content of the record with respect to the purpose of the cancellation provision of the form P. & R. agreements (R. 72), a point the Court of Appeals deemed relevant and pertinent. Nevertheless, rehearing was denied, Judge Harry E. Kalodner dissenting (R. 82-85).

SUMMARY OF ARGUMENT.

Petitioners are entitled to share in the depletion allowance provided for by Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939 to the extent of 5% of their gross income from coal mining operations undertaken pursuant to agreements with the landowner in the present case. It was the Petitioners who exercised control over the production of the coal and contributed the necessary capital outlays for the exploration, discovery and extraction of the coal, thereby incurring the risk of loss.

The depletion allowance was intended by Congress to encourage the very activities carried on by the Petitioners in the present case. Therefore, Petitioners fall within the class to whom the depletion deduction should be given.

This Court has held time and again that if a taxpayer acquires by investment *any* interest in the mineral in place and secures by any form of legal relationship income derived from the extraction of the mineral upon which the return of his capital is entirely dependent, then he qualifies for the depletion allowance.

The Petitioners herein have the requisite interest. Their agreements with the landowner conferred upon them the exclusive rights to mine the coal in the reserved areas. Since their reward for their operations lay solely in the extraction of the coal, which the landowner agreed to buy at a fixed price, they were completely dependent upon extraction of the coal for the return of and a profit upon their investment.

The concept of "investment" is synonymous with the concept of "interest". Both refer to rights over production of the mineral upon which income depends. Furthermore, Petitioners literally acquired their interest by investment through their commitment to devote their entire resources to the undertaking. And, in fact, Petitioners did make a vast capital outlay in the stripping project in discovering the coal, in preparing the land for extraction, and

in acquiring costly equipment for the actual mining of the coal. This "investment" was the consideration for which the landowner granted the Petitioners the production rights contained in the agreements.

Although the landowner could terminate the Petitioners' rights upon thirty days' notice, in fact it did not, and the contracts were terminated by mutual agreement of the parties only after the coal tracts were mined to exhaustion by Petitioners. Moreover, since depletion depends upon extraction and is calculated upon the gross income therefrom, the possiblity of termination is an irrelevant consideration. The depletion deduction results in no tax benefit to Petitioners other than that which they earned by extraction and sale of the coal.

Certainly, the fixed price arrangement does not militate against Petitioners' right to the depletion allowance, since such method of payment does not render the Petitioners independent of extraction for the return of their investment in the coal in place. The payment was based on current market conditions and both Petitioners and P. & R. bore the risk of future fluctuations of the market.

Petitioners undoubtedly have that economic interest which alone is the prerequisite to obtaining the depletion allowance. The decisions of the Courts below are in direct conflict with the rule as applied by this Court in *Commissioner v. Southwest Exploration Co.*, 350 U. S. 308 (1956), and *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25 (1946).

ARGUMENT.

I. The Petitioners Are Entitled to the 5% Depletion Allowance on Their Gross Income Received as a Result of Their Mining Activities Herein.

Section 23(m) of the Internal Revenue Code of 1939 (*infra*, Appendix A, page 19) states that a reasonable allowance for depletion shall be allowed as a deduction in computing net income in the case of mines. In the case of leases, it is specifically provided that the deduction shall be equitably apportioned between the lessor and the lessee.

The issue presented for decision in this case is, therefore, whether the Petitioners are entitled to share in the depletion allowance, i.e., whether they are entitled to the depletion allowance with respect to gross income from their mining operations. If the Petitioners are so entitled, then the landowner must deduct the amounts paid to the Petitioners in determining its depletion allowance with respect to its gross income from the coal Petitioners mined. This is so because the aggregate of the deductions for percentage depletion taken by all parties sharing in the production and conversion into gross income of the coal cannot exceed 5% of the gross income from the property, i.e., gross income from mining.[1]

1. Section 114(b)(4) of the 1939 Code (*infra*, Appendix A, page 20), specifies that percentage depletion for coal mines shall be 5% of the gross income from the property during the taxable year, excluding an amount equal to rents or royalties paid or incurred by the taxpayer in respect of the property. "Gross income from the property" is defined as meaning gross income from mining, and "mining" is defined to include not merely extraction, but also ordinary treatment processes normally applied by "mine owners or operators" in order to obtain the commercially marketable mineral product.

A. The Depletion Allowance Is Granted to One, in the Position of Petitioners, Who Has an Economic Interest in the Mineral in Place.

The law of depletion requires an economic rather than a legal interest in the mineral in Place. *Commissioner v. Southwest Exploration Co.*, 350 U. S. 308, 316 (1956); *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599, 603 (1946). Title to, or ownership of, the mineral deposit is not necessary nor is the nature of the instrument creating the rights significant. And, even though under local law a taxpayer may not be regarded as having a legal interest in the mineral in place, he may nonetheless have acquired a depletable interest. *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, 32-35 (1946); *Kirby Petroleum Co. v. Commissioner, supra; Burnet v. Harmel*, 287 U. S. 103 (1932); *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (1925).

This Court recently reiterated in *Commissioner v. Southwest Exploration Co., supra*, at 314, the holding of *Palmer v. Bender*, 287 U. S. 551, 557 (1933), that the requisite economic interest exists in every case in which the taxpayer has acquired, by investment, any interest in the mineral in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which he must look for a return of his capital.

What marks an economic interest in the mineral in place is the possibility of profit from the use of rights over production, dependent solely upon the extraction of the mineral and its conversion into gross income. *Commissioner v. Southwest Exploration Co., supra*, at 316; *Burton-Sutton Oil Co. v. Commissioner, supra*, at 34-35. Legal ownership may in any case exist in another, but where control over production exists, the person in whom it resides acquires an economic interest which represents his capital investment and is subject to depletion. *Palmer v. Bender, supra*, at 557; *Lynch v. Alworth-Stephens Co., supra*, at 370.

B. The Petitioners Had an Economic Interest in the Coal in Place by Virtue of Their Right to Extract the Mineral, Their Assumption of All Risks of Discovery and Production, and Their Complete Dependence Upon Extraction of the Mineral for Their Return.

In the case *sub judice*, the Petitioners acquired an exclusive right to all the coal recoverable by strip-mining from the areas specifically reserved to them. They assumed all risks of discovery and production. Indeed, as the agreements show on their face, Petitioners were engaged in salvage stripping in previously deep-mined areas, and the risk of finding and producing such amounts of commercial quality coal, as would render their commitments and expenditures economically feasible, was significantly increased. The Petitioners determined where and when to begin and where and when to stop mining. They actually mined to exhaustion all the areas involved, and the agreements were thereafter terminated only by the mutual assent of the Petitioners and P. & R. Moreover, Petitioners had no recourse to recover any of the expense of prospecting and mining except through the production of coal, which P. & R. agreed to buy at a specific, pre-determined price per ton.

Whether the agreements be characterized as leases or licenses is immaterial; their significance is that they gave Petitioners control over the extraction of the coal and thus created an interest in the coal in place in the Petitioners. And, since Petitioners were entitled to payment only for coal produced, it is obvious that they secured by legal relationship income derived from the extraction of the coal, to which they necessarily looked for a return of their capital.

The treatment of this subject in the Court of Appeals, however, demonstrates fundamental error; the Court saw in the requirement that an interest in the mineral be acquired by investment the necessity for "capital expenditure".

It is respectfully submitted that the term "investment", as used in the concepts related to percentage depletion, and as used in the *Kirby Petroleum Co., Burton-Sutton Oil Co.* and the *Southwest Exploration Co.* decisions, is synonymous with "economic interest." It cannot matter that the interest was acquired at a nominal price, or even that it was acquired by gift or devise. As stated in the *Burton-Sutton Oil Co.* decision, *supra*, 34:

> "The cost of that investment to the beneficiary of the depletion under Section 114(b)(3) is unimportant. * * * Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors of partial *exploitation rights* in oil lands has maintained a *capital investment* or *economic interest* in the oil or its proceeds." (Emphasis supplied.)

If the Petitioners here had assigned their rights over production to a third party, reserving to themselves a royalty on each ton of coal extracted, they would have been in the same position as the assignor whose right to percentage depletion was upheld by this Court in the *Burton-Sutton Oil Co.* case. Petitioners cannot lose their tax benefit because they chose to exercise their rights over production through extracting the coal themselves.

Furthermore, Petitioners literally acquired their interest by investment through their commitment to devote their entire resources to the undertaking. And, in fact, Petitioners did make a vast capital outlay in the stripping project in discovering the coal, in preparing the land for extraction, and in acquiring costly equipment for the actual mining of the coal. This "investment" was the consideration for which the landowner granted to the Petitioners the production rights contained in the agreements.

Accordingly, the only proper conclusion is that Petitioners did acquire, by investment, an interest in the mineral in place.

Until the decision in the instant case, the Courts of Appeals presented with the issue of the entitlement of a

strip miner to the depletion allowance have consistently held, in circumstances similar to those here, in his favor. *Commissioner v. Hamill Coal Corp.*, 239 F. 2d 347 (4th Cir. 1956); *Weirton Ice and Coal Co. v. Commissioner*, 231 F. 2d 531 (4th Cir. 1956); *Commissioner v. Mammoth Coal Co.*, 229 F. 2d 535 (3d Cir. 1955), *cert. denied*, 325 U. S. 824; *Stilwell v. United States*, 250 F. 2d 736 (4th Cir. 1957); *Commissioner v. Gregory Run Coal Co.*, 212 F. 2d 52 (4th Cir. 1954), *cert. denied*, 348 U. S. 828. *But cf., Usibelli v. Commissioner*, 229 F. 2d 539 (9th Cir. 1955).

C. Neither the Power of P. & R. to Terminate the Agreements Upon Thirty Days' Notice, Nor Its Obligation to Pay a Fixed Price Per Ton of Coal Delivered Prevented the Petitioners From Acquiring an Economic Interest in the Coal in Place.

1. *The Power of P. & R. to Terminate the Agreements Upon 30 Days' Notice Is Irrelevant to the Determination of Petitioners' Interest in the Coal in Place.*

Although the Court of Appeals thought that it was a reasonable conclusion on the facts of the case that the Petitioners had an interest in the mineral in place, it permitted the judgments of the District Court to stand. In the Court of Appeals' view, the appraisal of the significance of the power of termination was a matter of factual inference for the District Court.[2] In so holding, the Court of Appeals committed error, since the relationship of the power of termination to "economic interest" is a matter of law.

2. It should be noted that the Court of Appeals misapprehended the content of the record. As Judge Kalodner pointed out in his dissent to the denial of rehearing,

> "The record here discloses that the termination clause was included in the contract as a precaution on the part of the owner to protect itself from difficulties with an incompetent stripper. It may be noted parenthetically that in the opinion sought to be reconsidered it was erroneously stated 'We are not told the reason for including this cancellation clause.'" (255 F. 2d, at 602; R. 84)

The net effect of the holding of the Court of Appeals is to treat the Petitioners as though P. & R. had actually exercised its power of termination, as though the thirty day period had thereafter expired, and thus as though the right of Petitioners to extract the coal had been rendered non-existent. But the facts are just the contrary.

The power of termination was purely legal. Unless and until it had been exercised, it could not affect the Petitioners or their economic relationship to the coal in place.

We are here dealing with economic realities, not legal abstractions; we are concerned with facts, not with possibilities which did not occur. *Commissioner v. Southwest Exploration Co., supra,* at 315, 316. No contract was terminated unilaterally by P. & R., but the contracts were terminated only by the express written agreement of both P. & R. and Petitioners after Petitioners had, in their judgment, mined the coal to exhaustion. The value of the right of extraction which Petitioners enjoyed, notwithstanding the existence of a power of termination, is accurately reflected by their investment of $500,000. in mining equipment purchased for the operations, as well as by the capital outlay they made for the construction of roads, building, supplies and materials, and for the general financing of the mining operations.

The Court of Appeals cannot properly change the relationship of the parties. It cannot properly superimpose its judgment upon the parties, and treat as exercised, contractual powers which the parties did not choose to exercise, nor may it interpret those powers in a manner contrary to the parties' own interpretation as demonstrated by the actual facts.

As Judge Kalodner pointed out in his sharply defined dissent from the denial of the Petition for Rehearing, an unexercised power of termination does not negate the existence of an economic interest in the mineral in place. "That such right [to mine the coal] might have been brought to an end does not affect the present fact that

the economic interest existed." (255 F. 2d, p. 603; R. 84.) "The Commissioner and the courts must deal with a situation as it exists during the taxable year involved and not as it might exist in some future year because of the possible occurrence of an event through the exercise of a contractual right." (255 F. 2d, p. 602; R. 83.)

Judge Kalodner's view is fully and completely supported in this regard by the decisions of the Fourth Circuit. See *Commissioner v. Hamill Coal Corp., supra; Weirton Ice and Coal Supply Co. v. Commisssioner, supra.*[3]

2. *The Right of Petitioners to Receive a Stated Price Per Ton of Coal Is Consistent With Their Possession of an Interest in the Coal in Place.*

The Court of Appeals found nothing in the price arrangement between Petitioners and P. & R. to suggest that Petitioners acquired an interest in the coal in place. Precisely what the Court of Appeals was seeking does not appear.

It is not disputed that Petitioners were entitled to payment only for coal discovered, extracted and delivered to P. & R. It is plain, therefore, that they secured by legal relationship income derived from the extraction of the coal, to which source alone they looked for the return of their capital. No more is required. *Commissioner v. Southwest Exploration Co., supra,* at 314.

The complete dependence of Petitioners upon extraction of the coal for their return is not lessened because

3. In the *Weirton* case, the Court offered this terse comment on the right of termination:

> "It is of no moment that the owner of the mineral, as in other cases in which the right of the extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all the taxable years." (231 F. 2d, p. 535)

The Internal Revenue Service, for reasons unknown, takes the position that a stripper is not entitled to the depletion allowance if his contract is terminable upon less than one year's notice. G. C. M. 26290, 1950-1, Cum. Bull. 42.

they did not contract to receive a percentage of the income from the ultimate sale of the coal by P. & R.

It was early determined that nothing in the tax statute precludes Petitioners from disposing of the coal extracted by them at a fixed price. *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166 (N. D. W. Va., 1946). The Court of Appeals for the Fourth Circuit, in *Hamill, Weirton, Stilwell,* and *Gregory Run,* as well as the Court of Appeals for the Third Circuit in *Mammoth,* fully agreed.

Petitioners chose to make a stable price bargain under existing market conditions, thereby sacrificing the benefit of any market increase in order to protect themselves against any market decrease. They substituted one risk for another. Certainly this cannot operate to deprive them of their right to the depletion allowance.[4]

II. The Petitioners' Role in the Production of the Coal Brings Them Within the Class Intended to Enjoy the Benefit of the Percentage Depletion Allowance.

The depletion deduction was not given solely to permit recoupment of a capital investment. As this Court said in *Commissioner v. Southwest Exploration Co., supra,* at 313:

> "The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted and even though no money was actually invested in the deposit. The depletion allowance in the Internal Revenue Code of 1939 is solely a matter of legislative grace * * *."

The depletion allowance was provided to stimulate prospecting, exploration and production of minerals. Sen.

4. The fixed rates of payment here involved are analogous to the flat royalty payments sanctioned in *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599 (1926); *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (1925).

Rep. No. 617, 65th Cong., 3d Sess., 1939-1 (Part 2) Cum. Bull. 121-122; H. R. Rep. No. 1, p. 6, 69th Cong., 1st Sess., 1939-1 (Part 2) Cum. Bull. 319; Statement of Senator Reed, 67th Cong. Rec. 3561-3578; Statement of Senator Gore, 78th Cong. Rec. 6182-6183. These records leave no room for doubt that it was the purpose of Congress to encourage taxpayers in the situation of Petitioners and to reward them for the assumption of the inherent risks of discovery and extraction. The Code of 1939 not only simplified the determination of the allowance, but reflected the further need to promote mining by allowing percentage depletion without regard to whether the mine represented a new discovery. See 4 Mertens' Law of Federal Income Taxation, § 24.31a (1954).

It is self evident that P. & R. was primarily interested in the handling of coal following its production. A casual reading of the form agreements which it prepared conclusively demonstrates that it desired to be relieved of the substantial risk of discovering commercial quality coal in adequate quantities to render economically justifiable the tremendous investment required for the salvage mining operation. Indeed, it will be seen from an inspection of these forms of agreements which P. & R. prepared, that P. & R. securely tied that risk to the Petitioners.

The Petitioners manifestly played the major and integral role in the actual production of the coal. They brought to the mining operation the benefit of their experience and the commitment of their resources. Their equipment, usable only for strip mining, constituted a substantial capital investment. Petitioners contributed the capital necessary to prospect for and discover the coal and to extract it from the ground, to build roads and construct buildings. All of these expenditures increased the risk undertaken, since the Petitioners looked solely to production for the return of their investment.

It is respectfully submitted that the Petitioners come within the purview of the applicable statute, and that they

are beneficiaries of the legislative grace by natural qualification, since the functions performed by them are precisely those sought to be encouraged and rewarded by Congress through the depletion deduction.

CONCLUSION.

Petitioners have satisfied every requirement for the depletion allowance, *Commissioner v. Southwest Exploration Co., supra*, and therefore the judgments of the Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX A.

Pertinent sections of the Internal Revenue Code of 1939 provide:

Sec. 23. Deductions from gross income. In computing net income there shall be allowed as deductions:

* * *

(m) Depletion. In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * *

(n) Basis for depreciation and depletion. The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

(53 Stat. 12, 14, 26 U. S. C., 1952 ed., Sec. 23.)

* * *

Sec. 114. Basis for Depreciation and Depletion.

* * *

(b) Basis for Depletion.

* * *

(4) [As amended by Sec. 145(a), Revenue Act of 1942, c. 619, 56 Stat. 840, and Sec. 124(a-c), Revenue Act of 1943, c. 63, 58 Stat. 44, 45 Percentage depletion for coal * * *

(A) In General. The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum * * * of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property * * *.

(B) Definition of Gross Income From Property. As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining" as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. * * * The term "ordinary treatment processes" as used herein shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; * * * *

(53 Stat. 45, 26 U. S. C. 1952 ed., Sec. 114.)

Treasury Regulation 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23 (m)-1. Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements. Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

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